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Economic Outlook

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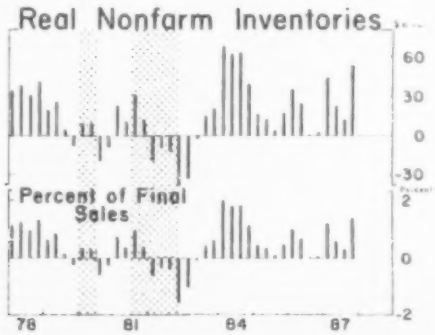
Fourth-quarter GNP growth at 4.2% was well above market expectations. However, the increase was largely due to a surge in inventory investment, raising questions about the sustainability of future growth. Sluggish retail sales, rising claims for unemployment insurance, and a small increase in January payroll employment also point to slower growth ahead. Is the current slowdown a pause that refreshes, while stock market aftershocks subside? Or is it the beginning of a prolonged decline to recession? A closer look at the statistics suggests that the current signs of weakness are hardly sufficient to preclude continued expansion in 1988, especially later in the year. To the contrary, the current slowdown is likely to extend the expansion by prolonging a lower interest rate environment and deferring the buildup of inflationary pressures until later this year. Only then will monetary policy face a harder choice between further expansion and higher inflation.

A major contribution from inventories had been expected for the fourth quarter. Consumer and producer spending on motor vehicles surged in the third quarter as automobile producers launched major incentive programs to clear dealer lots for the new model year. Most of the inventory swing in the fourth quarter was in the motor vehicle sector as consumers and businesses slowed their purchases from the extraordinary pace of the third quarter. The slowdown in auto purchases was deepest in October, and sales have picked up to healthier levels since then.

The large fourth-quarter increase in nonfarm inventories followed a sluggish increase in the third quarter (see chart). A sharp slowdown in inventory investment this quarter will probably have a big negative impact on growth, but this should be offset by the pickup in sales from temporarily depressed levels. There is little reason to expect a longer-term slowdown. Recall that in the first quarter of 1987 inventories contributed a comparable amount to GNP growth, yet overall growth remained high in 1987. This earlier inventory buildup also followed a spike in auto sales.



Aside from motor vehicles, there does not appear to be much of an excess inventory problem. Nonauto manufacturers have inventories well under control. In the fourth quarter, nondurable goods inventory investment barely changed. This was true at the manufacturing, wholesale, and retail levels. While there may be pockets of inventory excess, the ratio of inventory to final sales is not out of line with normal levels in an expansion. Since the ratio is likely to go down in this quarter as sales outpace inventory investment, the economy

should be poised for faster expansion later in the year. Also helping to avoid a sharper domestic production slowdown are high levels of imported car inventories, which grew at a faster rate than domestic cars. Imports account for about a third of the recent growth in car inventories. Working these inventories down should help improve the trade deficit. So while inventories are likely to depress first-quarter growth, the problem is unlikely to persist beyond the current period.

Consumer confidence has risen recently from the lower levels that followed the stock market crash and remains in expansion territory. Business confidence appears to have been shaken a bit as managers making end-of-the-year changes seem to have responded to fears of a slowdown by laying off more workers and slowing hiring in January. But it is premature to conclude that this is a trend. The household employment survey showed a strong increase in January, the unemployment rate remained at the same low level, and the turn-of-the-year statistics are harder to fathom because of seasonal adjustment problems.

The outlook in most of the industrial sector is less murky. Continued strong new orders, lean inventories-to-sales ratios, and a building backlog of unfilled orders all point to continuing expansion. Export growth remains strong. Considerable new stimulus remains from the year-end dollar decline. Increasing capacity utilization rates should make capital spending an important source of growth this year. Weighing the signs of strength and weakness, the balance still comes down on the side of further expansion. Look for faster growth after the first quarter.

Robert T. McGee

Real GNP

(Percent Contribution to Real GNP Growth; Annual Rates)	Actual 1987 I	1987 II	1987 III	1987 IV	Forecast 1988 I	1988 II	1988 III	1988 IV	Actual 1986-1987	Forecast 1987-1988	Forecast 1988-1989
Consumer Spending	-0.5	1.2	3.5	-2.5	1.3	0.8	1.0	1.0	1.2	0.7	0.5
Business Investment	-1.9	1.3	2.8	-0.4	1.5	0.8	0.8	0.6	0.1	1.0	1.0
Residential Investment	-0.4	-0.2	-0.4	0.3	-0.1	-0.1	-0.1	-0.1	0.0	-0.1	-0.2
Change in Inventories*	4.4	-1.6	-1.5	5.5	-2.4	0.5	0.4	0.3	0.5	0.3	0.0
Net Exports	1.8	0.3	-0.6	0.8	1.2	0.9	0.7	0.9	0.3	0.7	0.6
Government Purchases*	1.0	1.5	0.5	0.5	0.5	0.5	0.5	0.5	0.8	0.6	0.4
Real GNP	4.4	2.5	4.3	4.2	2.0	3.4	3.3	3.2	2.9	3.2	2.3

Quarterly Economic Indicators

(Percent Changes at Annual Rates)	Actual 1987 I	1987 II	1987 III	1987 IV	Forecast 1988 I	1988 II	1988 III	1988 IV	Actual 1986-1987	Forecast 1987-1988	Forecast 1988-1989
Nominal GNP	8.6	6.3	7.3	6.7	5.7	8.0	8.9	9.1	5.9	7.2	8.5
GNP Deflator	4.2	3.5	2.8	2.6	3.5	4.5	5.3	5.7	2.9	3.8	6.1
Corporate Profits After Tax#	6.7	10.0	9.0	6.3F	12.5	10.1	8.5	6.9	9.0	9.5	6.0

Monthly Economic Indicators

	Recent Data Nov.	Dec.	Jan.	Actual 1987	Forecast 1988	Forecast 1989
Consumer Price Index** (%)	0.3	0.1	n.a.	4.4	5.3	6.2
Industrial Production (%)	0.4	0.2	n.a.	3.7	5.1	2.7
Retail Sales (%)	0.1	0.7	n.a.	3.4	4.4	5.2
Auto Sales (million units, a.r.)	9.8	10.9	n.a.	10.3	9.8	8.8
Housing Starts (million units, a.r.)	1.64	1.37	n.a.	1.64	1.53	1.35
Unemployment Rate (%)	5.9	5.8	5.8	6.2	5.5	5.5
Merchandise Trade Deficit ($ bn., a.r.)	-158.6	n.a.	n.a.	-173.0F	-145.0	-110.0

*Adjusted for CCC purchases. **Annual percent changes are December to December. February 10, 1988
#Quarterly data are year-over-year percent changes. F = Forecast
a.r. = annual rate